

World Overview

Growth: Many of the world's developed economies have now entered recession, with Q2 GDP figures being revised downward in the US, Japan and Canada. China and Australia are still growing but look set to slow. Car sales are usually a reliable indicator of oncoming recession: in the US light vehicle sales will fall by around 15% in 2008, the sharpest drop since the early 1990s. Employment growth has stopped and job losses are starting to pick up in the US, Euro zone and UK, with corresponding weakness feeding into lower disposable incomes. The future looks bleak and those developed economies that have not seen a contraction in output yet, will do so over the next 2 years.

Inflation: Inflation is still high relative to target in most countries but has peaked and is easing. Going forward reduced demand, from weakened economic activity and lower incomes, will continue to provide downward momentum. Thankfully, oil, food and commodity prices have not continued on their rapid pace of increase; a resumption of high raw material inflation would be disastrous at this juncture. In Japan inflation is high in aggregate but this is driven by food and energy related items; goods prices are still falling. Euro zone inflation at 3.6% is way above the 2% target but has peaked over the summer.

Policy: Central banks have been frantically injecting liquidity into the markets and it now seems that inflationary pressures eased sufficiently for rate cuts to start. However, even in 'normal' times it will take 6 to 12 months for monetary policy to have an impact on the real economy. But, times are not 'normal' and whilst rate cuts will help sentiment and bank profitability the impact on output and spending will be limited. A US 'rescue package' has been enacted, which should help to ease the banking crisis, but will take time to come into force.

Region by Region (changes in bold)

	Growth	Inflation Rate	Short Int Rate
USA	Weakening	Peaking	Falling
Euro zone	Weakening	Easing	Falling
UK	Weakening	Easing	Falling
Japan	Weakening	Peaking	Stable
Canada	Weakening	Peaking	Stable
China	Moderating	Easing	Stable
Australia	Moderating	Easing	Falling

How close are we to a new, 'Great Depression'?

This month we join the throng of commentators drawing parallels between the great depression in the 1930s and the current 'turbulence'. Here, we present a basic but systematic assessment of whether the forces acting in the great depression are present now and their magnitude. The good news is that many factors that contributed to the depression are weaker or not present. The bad news is that some important ones are, and, on balance, things are getting worse. The box below gives some of the key facts from the 1930's US depression. Finally, although the great depression is often thought of as an event in US history and indeed it reached its nadir in this country, it was a global event.

The Great Depression in the US was a true 'economic meltdown'. Unemployment rose from 3.2% to 25% by the mid-1930s: 1 in 4 had no job. Industrial output fell by almost 50% and family incomes contracted by nearly 40%. Many lost their homes and, although food prices fell by 50%, people were so poor foodstuffs could not be sold for profit. By 1932 investment was only 5% of its 1929 level. The US was hit worst but other countries also suffered. The mid-1930s showed some recovery but unemployment in the US was still at 14% at the outset of WWII.

Table 1 gives a list of the factors thought to have contributed to the great depression. The relative

importance of these factors can be debated but the following is a brief explanation of each factor¹. A **cyclical downturn in investment** after a period in which firms had expanded strongly: the 1920s saw unprecedented productivity gains, driven by increases in capital at the expense of labour as seen in automobile production. Such downturns are often abrupt and cause the capital goods industries to shed labour quite dramatically. Another example is the slump in production of ICT equipment in the late 1990s. A big similarity between the 1920s and now **was the strong build up of debt** by consumers and businesses, particularly in the US, related to a period of extremely low interest rates. In fact, the stock market bubble of the 1920s was in its latter stages fuelled by bank lending to small investors. One short-term cause of the great depression was **tightening monetary policy** and current OECD interest rates started to rise around 2005 to restrain demand and keep inflation under control. In the 1920s, there was no goods inflation but the Fed started to raise rates in 1928 to curb equity price boom. Monetary policy in other countries was geared to **restoring the gold standard**, namely the ability to exchange currency for gold, on demand. Generally this implied a deflationary contraction of the money base. Today's equivalent is the fight against inflation which has forced interest rates up across the OECD.

Table 1:
Current relevance of factors causing the 'Great Depression'

Present in 1930s Downturn	Present Now				Rank	Max	Actual
	1	2	3	4			
Cyclical downturn in investment			X		2	8	6
Massive build up of debt in preceding decade				X	3	12	12
Tightening monetary policy in preceding 24 months				X	3	12	12
Tightening monetary policy during the crisis due to gold standard		X			3	12	6
Stock market crash (85% down in 30 months)		X			3	12	6
Widespread bank failures		X			3	12	6
Absence of government support for banks	X				3	12	3
Decline in trade due to increased tariff barriers	X				2	8	2
Agricultural disruption		X			1	4	2
Deflation		X			2	8	4
Narrow economies based on capital goods industries	X				2	8	2
Highly unstable geopolitics (based on unresolved issues from WW1)	X				2	8	2
Total						116	63

Rising interest rates will always hit asset values and this, combined with limited earnings growth potential, hit the 1929 stock market, with a decline of 85% in the US over 30 months. US stock values did not regain their 1929 level until 1954. This is much worse than recent events: in 2000 markets fell about 45% but bounced back by 2007. Since then they have declined by around 28%, but are still falling at the time of writing. In the US, as firms went bust and workers were laid off, **banks which had lent excessively began to fail**. Approximately 9000 banks failed in the 1930s and depositors lost \$140bn (approx. \$850bn in today's money). The supply of credit to the economy ceased and, it is argued, the **authorities failed to provide support** to banks until it was too late. It's the same today, many banks are in trouble following a period of "reckless" lending, but this time a comprehensive "bailout" package

is coming to the rescue. A bizarre policy response in the 1930s to the economic turmoil was that the **US increased tariffs on imports**, which brought retaliation, resulting in a 50% drop in world trade. There is no real equivalent today. Due to the slump in demand in the early 1930s a vicious cycle of **deflation** set in, which impacted negatively by increasing the real value of their debts. Japan experienced a similar bout of 'debt inflation' in the 1990s but we are some way from that now.

Other factors creating the depression include: a **drought** in the US hitting agricultural incomes; the rise of **fascism and militarism** in Europe and Japan; and the generally **undiversified nature of national economies** (i.e. small number of main business sectors and small public sector).

Table 1 shows the extent to which we think the 'Great Depression' factors are operating now (1=not at all; 4=strong basis). It also ranks the importance of these factors in the 1930s (1=low: 3=high basis). If all the factors were operating strongly today the total from multiplying the presence score by the importance score would be 116. In fact, because not all of the factors are operating today the score is only 63. So, we have, approximately 54% of the factors associated with the Great Depression, in place now. This leaves us facing a nasty recession but not a great depression. Also, things should begin to improve as inflation falls and interest rates are cut. The US big bailout is important, without it our Great Depression score would be 72 (64%). However, it remains to be seen how effectively this injection of tax payers' money can actually be deployed.

¹ a fuller discussion can be found on http://en.wikipedia.org/wiki/Great_depression